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What Growth-Stage Biotech and Pharma Companies Need to Know About the PvP Rules

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On August 25, 2022, the SEC finalized long-awaited rules on pay versus performance (PvP) disclosures for both Smaller Reporting Companies (SRCs) and Large Accelerated Filer public companies. Emerging Growth Companies are excluded from this new disclosure requirement. The rules are quite detailed on what needs to be done to comply, but unfortunately there are a number of areas that may present particular challenges in the biotech and pharma industry. This article highlights some of these potential traps and identifies key areas of focus for boards and management teams as they begin preparation on these new disclosures.

A New Reporting Requirement: "Compensation Actually Paid" (CAP)

What companies are affected?

SRCs and Large Accelerated Filers must comply.

What is it?

"Compensation Actually Paid" is a new concept for SEC reporting, developed specifically for the new PvP disclosure rules. Our earlier client alert covers the detailed definition of CAP. The most important change in how compensation is disclosed focuses on valuing (and revaluing) long-term incentive awards (e.g., stock options) throughout their cycle, and in the year of vest.

Why is that an issue?

Unfortunately, similar to how long-term incentive awards are presented in the Summary Compensation Table, the CAP calculation methodology relies on a fair-market valuation model (Black-Scholes, Lattice model, etc.). This approach ascribes a value to an option award even if that award is out of the money (i.e., "underwater"). For executives who may hold little to no realized value in their equity holdings due to a decline in the company's share price, readers of the disclosure may conclude that substantial value has been earned. Most early-stage bio/pharma companies rely heavily on stock options as a key component of total compensation for Named Executive Officers (NEOs), and thus the numbers that are presented in the CAP column are unlikely to reflect what the NEO has "Actually" been paid. Further, the valuation work is substantial given that many companies in this space use monthly or quarterly vesting schedules, which will require a new valuation for each vesting tranche.

What is the solution?

We anticipate that many biotech and pharma companies will consider adding a supplemental table to the disclosure that more clearly illustrates the intrinsic or "paper" value of the equity awards as a way to more clearly illustrate the link between company stock price performance and NEO CAP. This exercise should not add a significant amount of work to the process since most of the modeling will have been done to support the new CAP calculation that is required. The key change will be to recalculate the value of the awards on an in-the-money basis as opposed to a fair-value basis. We are advising clients to work through both the SEC required and supplemental table, as part of the planning process.

The Definition of Performance: Total Shareholder Return and Net Income

What companies are affected?

SRCs and Large Accelerated Filers must comply.

What is it?

The new tabular disclosures require that a company provide a multi-year look back of total shareholder return (TSR) and Net Income.

Why is that an issue?

The lifecycle for pre-commercial bio tech and pharma companies is typically influenced by significant R&D, clinical, and regulatory milestones that rarely sync up with an annual reporting cadence. Therefore, we see two primary issues with this approach to defining performance:

1. Net Income is likely an irrelevant metric for executive compensation purposes, and thus comparing it to compensation is a flawed exercise that will likely draw the reader to inappropriate conclusions.
2. TSR is a reasonable metric to use in comparing executive compensation to performance; however, the date dependency of the metric, coupled with significant share price volatility, can create an artificial view of performance.

What is the solution?

We are advising clients that robust narrative disclosure will be required to provide additional context related to how the most important company measures align with pay. For example, companies may choose to highlight the key scientific and operational advancements in the preceding year(s) that are more closely tied to compensation.

Comparing Peer TSR Performance

What companies are affected?

Large Accelerated Filers must comply.

What is it?

The SEC requires that companies compare their TSR to either the peer group used for executive compensation determination, or the index used for 10-K stock price performance comparisons. If the company uses its own compensation peer group, it must provide additional footnote disclosure identifying the companies in the peer group. Additionally, if this peer group changes year over year, extensive footnotes will be needed showing a comparison of the TSR that would have been reported using the former peer group.

Why is that an issue?

The volatility that is a hallmark of the pre-commercial biotech and pharma sector often necessitates at least an annual review of the peer group used for executive compensation benchmarking purposes. In a typical year, early-stage companies may replace 20-30% of the prior list due to a combination of stock price movement, change in size and/or stage of company, or M&A activity, which is common across the sector. While an annual review and refresh of the executive compensation peer group reflects a best practice from a governance perspective, we are concerned that these annual changes will require lengthy footnotes attached to the PvP table and complicated calculations to accurately capture peer TSR values over a multi-year period.

What is the solution?

We anticipate many companies will utilize an index to present the TSR calculation, as the index approach will not require substantial footnotes. However, companies should be mindful that the index selected for the PvP table may result in TSR values that significantly deviate from the company's executive compensation peer group. If this is the case, a supplemental table more clearly illustrating the alignment of executive pay to peer group practices may be appropriate.

The Company-Selected Measure (CSM)

What companies are affected?

Large Accelerated Filers must comply.

What is it?

The required PvP table includes a column on the far right which is designed to provide the reader with additional detail on the critical *financial* performance metric (aside from TSR and Net Income, which are obligatory) that the company uses to link CAP with company performance.

Why is that an issue?

With limited exceptions, financial measures are not key drivers of executive compensation among development-stage biotech and pharma companies. These companies instead anchor incentive structures (both short-term and long-term plans) on key R&D, clinical, and regulatory milestones rather than financial goals.

What is the solution?

The SEC allows omission of the CSM column if the company does not use financial metrics (other than Net Income) to determine executive compensation. While this will simplify the disclosure, it may deprive the reader of important context on performance. Therefore we would advise that companies (1) make use of the supplemental performance table that is part of the SEC's rules, which allow for a listing of up to three additional financial metrics, and more importantly up to four *non-financial* metrics; and (2) make the proper case for pay and performance alignment in the narrative section of the Compensation Discussion and Analysis (CD&A) section, the narrative of the PvP table, or both.

Conclusions

There is a significant amount of work and coordination needed for all public companies to comply with the new disclosure requirements. In the biotech and pharma industry, additional challenges exist that will require even more thoughtfulness and creativity to ensure that the reader has a thorough understanding of the relationship of pay and performance. Getting ahead of the curve on the work—and the potential traps that your company may encounter—is of utmost importance. Plan ahead and get the right people on the work team now to ensure a good process and result come proxy season.

About the Author

Terry Newth is a managing director at Pearl Meyer. He consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries. Terry's areas of expertise include pay strategy and philosophy development, market-based pay studies, incentive plan design, severance and CIC arrangements, outside director pay, transaction-related compensation, CD&A and supporting table disclosures, corporate governance, and share plan authorizations.

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